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MICHAEL EDDY, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1978

No. 78-853

HAROLD CRAMER, Custodian for PATRICIA GAIL CRAMER,
Petitioner,
v.

GENERAL TELEPHONE & ELECTRONICS CORPORATION,
LESLIE H. WARNER, THEODORE F. BROPHY, JOHN J.
DOUGLAS, WILLIAM F. BENNETT and ARTHUR
ANDERSEN & CO.,

Respondents.

BRIEF OF RESPONDENT ARTHUR ANDERSEN & CO. IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI.

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INDEX.

	Page
OPINIONS BELOW	1
JURISDICTION	2
QUESTIONS PRESENTED	2
COUNTER STATEMENT OF THE CASE	3
Factual Background	4
ARGUMENT	6
A. The Third Circuit's Opinion Is Not in Conflict With the Other Circuits	6
B. The Lower Court Did Not Depart From the Accepted and Usual Course of Judicial Proceedings by Failing to Remand the Case to the District Court With Leave to Amend	9
C. The Judgment of the Court of Appeals as to Andersen Is Supported on the Additional Ground, Among Others, That Petitioner's Complaint Failed to Allege Scienter Against Andersen	9
CONCLUSION	10

TABLE OF CITATIONS.

Cases:	Page
Abbey v. Control Data Corporation, Civ. No. 4-78-187 (D. C. Minn., 1978)	8
Asher v. Harrington, 461 F. 2d 890 (7th Cir. 1977)	9
Auerbach v. Bennett, Index No. 572/77 (Sup. Ct. of Westchester Co., 1976)	3, 5
Banque de Depots v. National Bank of Detroit, 491 F. 2d 753 (6th Cir. 1974)	9
Bricker v. Crane, 468 F. 2d 1228 (1st Cir. 1972), cert. denied, 410 U. S. 930 (1973)	9
Cathedral Estates, Inc. v. Taft Realty Corp., 228 F. 2d 85 (2d Cir. 1975)	7
deHaas v. Empire Petroleum Corporation, 286 F. Supp. 807, aff'd., 435 F. 2d 1223 (10th Cir. 1970)	7
Ernst & Ernst v. Hochfelder, 425 U. S. 185 (1976)	10
Foman v. Davis, 371 U. S. 178 (1962)	9
Gall v. Exxon Corp., 418 F. Supp. 508 (S. D. N. Y. 1976) ...	8
Liboff v. Wolfson, 437 F. 2d 121 (5th Cir. 1971)	7
Limmer v. GTE [Current] CCH Fed. Sec. L. Rep. ¶ 96,111 (S. D. N. Y. 1977)	3, 5
Nelson v. Pacific Southwest Airlines, 399 F. Supp. 1025 (S. D. Calif. 1975)	8
Nussbacher v. Continental Illinois National Bank and Trust Company of Chicago, 518 F. 2d 873 (7th Cir. 1975), cert. denied, 424 U. S. 928 (1976)	7
Oldfield v. Alston, 77 F. R. D. 735 (N. D. Ga. 1978)	7
Papilsky v. Berndt, 59 F. R. D. 95 (S. D. N. Y. 1975)	7, 8
Tasner v. Billera, 379 F. Supp. 815 (N. D. Ill. 1974)	8
Zenith Radio Corp. v. Hazeltine Research Inc., 401 U. S. 321 (1971)	9
 Authorities:	
7A C. Wright and A. Miller, Federal Practice and Procedure, § 1831 (1977 Supp.)	6
3 Moore's Federal Practice, § 15.08(4)	9
3B Moore's Federal Practice, § 23.1.19 (2d Ed. 1924)	6

TABLE OF CITATIONS (Continued).

Statutes:	Page
CCH Fed. Sec. L. Rep. ¶ 96,510 (3d Cir. 1978)	1
Federal Rules of Civil Procedure, Rule 23.1	2, 3, 6, 8
1934 Securities Exchange Act:	
Section 10(b)	2, 3, 6, 10
Section 12(b)(1)	3
Section 13(a)	3
Section 14(a)	3
28 U. S. C. § 1254(1)	2

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OPINIONS BELOW

The opinion of the United States Court of Appeals for
the Third Circuit (Pet. 16a-43a) is reported at [Current]
CCH Fed. Sec. L. Rep. ¶ 96,510 (3d Cir. 1978). The

opinion of the United States District Court for the Eastern District of Pennsylvania (Pet. 44b-63b) is reported at 443 F. Supp. 516 (E. D. Pa. 1977).¹

JURISDICTION

The judgment for the Court of Appeals was entered on July 18, 1978 and a petition for a rehearing was denied on August 28, 1978. The petition for a writ of certiorari was filed on November 27, 1978. The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the Court of Appeals erred in affirming the District Court's dismissal of the derivative assertion of petitioner's section 10(b) claim on the ground that the petitioner failed to comply with the mandatory demand requirement of Rule 23.1.

2. Whether the judgment of the Court of Appeals in affirming the District Court's dismissal of the derivative assertion of petitioner's section 10(b) claim against Arthur Andersen & Co. ("Andersen") is supported on several grounds that were not passed upon by the Court of Appeals, including the failure of petitioner's Complaint to allege scienter against Andersen.

1. "Pet. —" refers to pages of the Petition for a Writ of Certiorari and "Pet. — a and b" refers to pages of the Appendices to the Petition.

COUNTER STATEMENT OF THE CASE

Petitioner, Harold Cramer, was the plaintiff in an action instituted derivatively on behalf of General Telephone & Electronics Corporation ("GTE") against GTE, four of its officers and directors and Andersen, GTE's "Independent Auditor". The Complaint charged all of the defendants with violating sections 10(b), 12(b)(1), 13(a) and 14(a) of the 1934 Securities Exchange Act ("Exchange Act") and with common law fraud and breach of fiduciary duty in connection with certain overseas payments by GTE.

The District Court dismissed the Complaint, finding that the section 13(a) and 14(a) claims were barred by the *res judicata* effect of *Limmer v. GTE* [Current] CCH Fed. Sec. L. Rep. ¶ 96,111 (S. D. N. Y. 1977); that the section 10(b) and 12(b)(1) claims were barred for failure to state a claim; and that the state law claims were barred by the *res judicata* effect of the decision in *Auerbach v. Bennett*, Index No. 572/77 (Sup. Ct. of Westchester Co., 1976) and lack of subject matter jurisdiction.

The Court of Appeals affirmed dismissal of the Complaint on the grounds that the section 13(a) claim failed to state a claim upon which relief could be granted; the section 14(a) claim was barred against the directors and Andersen, respectively, by the *res judicata* and collateral estoppel effect of the *Limmer* decision; and the section 10(b) claim was defective because petitioner failed to comply with the demand requirement of Rule 23.1.² The Third Circuit found it unnecessary to reach the question *inter alia*, whether the section 10(b) claim against Andersen was barred by petitioner's failure to allege scienter.

2. Petitioner did not appeal the correctness of the District Court's dismissal of his claim under section 12(b)(1) of the Exchange Act or the District Court's dismissal of his state law claims.

Factual Background

The Complaint contains only the following explanation of the claims asserted on behalf of GTE against the defendants (Pet. 19a):

"During a period commencing at a time unknown to plaintiff, and continuing at least until November, 1975, defendants, in violation of the Exchange Act and the Rules and Regulations promulgated thereunder and in violation of the Common law in connection with General participated, and/or acquiesced in, and/or aided and abetted, and/or failed to discover when in the exercise of due diligence they would have discovered, devices, schemes and artifices to defraud General, to waste the assets of General, to utilize the assets of General for unlawful purposes, to falsify the records of General, to defraud the United States Government by falsifying tax returns; to make untrue statements of material facts and to omit to state material facts in reports disseminated to shareholders of General; and, in the case of the individual defendants, breached their fiduciary duties and obligations to General."

The Complaint incorporates, as the specific factual predicate for these claims, a Report by the Audit Committee of the GTE Board of Directors, dated March 4, 1976, the full text of which was included in the proxy statement in connection with GTE's 1976 Annual Meeting (Pet. 19a and 48b).

The Audit Committee Report revealed that GTE and its subsidiaries had made foreign payments. The Report did not reveal any involvement in or knowledge of such payments on the part of Andersen.

After the Audit Committee Report was distributed to the GTE shareholders, three derivative actions, based upon the transactions revealed in that Report, were consecutively filed: first, *Auerbach v. Bennett*; second, *Limmer v. GTE*; and finally, the instant case. Andersen refers to and relies upon the statement by the Third Circuit of *Auerbach* and *Limmer*.

As noted by the Third Circuit, petitioner, in the instant action, failed to make a demand upon the GTE board of directors to institute the litigation before he filed his Complaint herein. The Complaint alleged, in conclusory language, that such a demand would have been futile because the Board was dominated by the four individual defendants and because the Audit Committee had not recommended litigation (Pet. 22a).

At the time the instant case was commenced, GTE's board of directors consisted of fourteen members, ten of whom were neither defendants in the instant case, nor involved in the transactions upon which the suit was predicated, and several of whom had not been on the board at the time of those transactions (Pet. 43a).

Similarly, the Audit Committee was composed of four outside, non-management directors who had not been involved in the questionable payments and none of whom was made a defendant in petitioner's litigation. The Audit Committee was authorized by the GTE board of directors to conduct an investigation to determine whether between January 1, 1971 and December 31, 1975, GTE or any of its subsidiaries had made questionable payments. The Audit Committee was not charged with determining whether to institute or recommend litigation relating to such payments (Pet. 42a).

ARGUMENT

This litigation presents no issue of significance to warrant the intervention of this Court. Petitioner is asking this Court to review whether the lower court properly exercised its discretion (a) in determining, under Rule 23.1 of the Federal Rules of Civil Procedure, that petitioner's Complaint failed to allege sufficient grounds for not making a demand upon the board of directors of GTE to pursue the litigation, and (b) in dismissing petitioner's section 10(b) claim on that ground.

Rule 23.1 determinations are discretionary and dependent upon the particular facts in each individual case. 7A C. Wright and A. Miller, *Federal Practice and Procedure*, § 1831 at 199 (1977 Supp.); 3B *Moore's Federal Practice*, § 23.1.19 at 83 (2d Ed. 1974). What petitioner contends to be a conflict among the circuits in judicial interpretation of Rule 23.1, is merely the application of a discretionary rule to different factual situations, generally by district courts.

Based upon the facts of record peculiar to the instant case, the lower court concluded that petitioner's Complaint did not and could not adequately explain why he failed to make a demand upon the board of directors. Accordingly, there is no basis for review by this Court.

Moreover, the judgment of the Third Circuit as to Andersen is supported on several additional grounds briefed and argued in the lower courts, including the absence of any allegation in the Complaint of scienter against Andersen.

A. The Third Circuit's Opinion Is Not in Conflict With the Other Circuits.

Petitioner contends that the Third Circuit's decision—that his Complaint failed to allege a sufficient reason for failing to make a demand upon GTE's Board of Direc-

tors—is in conflict with interpretations and decisions of the Second, Fifth, Seventh, Ninth and Tenth Circuits (Pet. 9). To the contrary, the decision of the Third Circuit is entirely consistent with the decisions petitioner relies upon, most of which are decisions of district courts.

In all of the cases relied upon by petitioner:

1. The Complaint alleged wrongdoing on the part of all or a majority of the directors. See e.g., *Nussbacher v. Continental Illinois National Bank and Trust Company of Chicago*, 518 F. 2d 873 (7th Cir. 1975), cert. denied, 424 U. S. 928 (1976); *Liboff v. Wolfson*, 437 F. 2d 121 (5th Cir. 1971); *Oldfield v. Alston*, 77 F. R. D. 735 (N. D. Ga. 1978) (the Fifth Circuit's "holding" according to petitioner); *Papilsky v. Berndt*, 59 F. R. D. 95 (S. D. N. Y. 1975) (the Second Circuit's "rationale" according to petitioner); or

2. Particularized facts were proffered to show that the alleged wrongdoers had effective control over the board. See e.g., *Cathedral Estates, Inc. v. Taft Realty Corp.*, 228 F. 2d 85 (2d Cir. 1975), where demand upon the board of directors of a vendor corporation to commence suit to set aside its sale of property to a vendee corporation was excused on the basis of a showing that: The plaintiffs had made a demand on the voting trustees to bring suit; the individual defendants, who were prime movers in the transactions complained of, had a 92% controlling interest in the vendor corporation and the officers, directors and voting trustees were their nominees; and these same defendants, as well as three of the five directors of the vendor, owned and controlled the vendee. See also, *deHaas v. Empire Petroleum Corporation*, 286 F. Supp. 807, 814 *aff'd*, 435 F. 2d 1223,

(10th Cir. 1970) (the defendants had "absolute control over the elective process within the corporation" and they were shown to have previously dictated the votes of the non-defendant directors) and *Nelson v. Pacific Southwest Airlines*, 399 F. Supp. 1025 (S. D. Calif. 1975) (the Ninth Circuit's "view" according to petitioner).

Such facts were neither alleged, nor of record, in the case herein. GTE's outside, non-management directors could not have "approved", "ratified" or "acquiesced in" the transactions complained of for the fundamental reason that they were never asked to consider whether GTE should institute legal proceedings relating to those transactions; and none of the cases cited by petitioner remotely suggests a different conclusion. *Abbey v. Control Data Corporation*, Civ. No. 4-78-187 (D. C. Minn., 1978) (a decision by a corporation not to sue does not constitute a ratification of allegedly criminal acts). Cf., *Gall v. Exxon Corp.*, 418 F. Supp. 508, 518 (S. D. N. Y. 1976) and *Tasner v. Billera*, 379 F. Supp. 815, 826 (N. D. Ill. 1974). Similarly, the mere fact that under these circumstances litigation is not begun, or that certain directors of a corporation are also its officers,³ has no conceivable bearing on the degree of control or dominance they may exercise over the corporation.

Applying the allegations of record to the above standards, the Third Circuit correctly held that petitioner did not adequately explain why he failed to make a demand on the directors.⁴

3. The court in *Papilsky* did not hold, as petitioner suggests, that the particularization requirement of Rule 23.1 was met by pleading the "strategic positions of the directors."

4. Conclusory allegations of futility of demand upon GTE's Board to sue GTE and its individual directors could not, of course, excuse such a demand upon them to sue Andersen.

B. The Lower Court Did Not Depart From the Accepted and Usual Course of Judicial Proceedings by Failing to Remand the Case to the District Court With Leave to Amend.

Petitioner has cited no authority for his fall-back contention that failure of the Court of Appeals to remand with leave to amend was improper and violative of established judicial procedures and has failed to demonstrate that this issue presents an important federal question justifying the attention of this Court. In addition, petitioner has made no showing that he sought the relief requested from the Third Circuit.

It is well established that courts have broad discretion whether to permit amendments and that such discretion, unless abused, is not subject to review. *Zenith Radio Corp. v. Hazeltine Research Inc.*, 401 U. S. 321, 330 (1971); *Banque de Depots v. National Bank of Detroit*, 491 F. 2d 753, 757 (6th Cir. 1974); 3 *Moore's Federal Practice*, § 15.08(4).

Such discretion was not abused under the circumstances of this case. See, *Foman v. Davis*, 371 U. S. 178, 182 (1962). Here, the Court of Appeals properly denied leave to amend when petitioner made no reference to any additional facts which, if pleaded, would satisfy Rule 23.1. See also, *Bricker v. Crane*, 468 F. 2d 1228 (1st Cir. 1972), cert. denied, 410 U. S. 930 (1973) and *Asher v. Harrington*, 461 F. 2d 890, 895 (7th Cir. 1972).

C. The Judgment of the Court of Appeals as to Andersen Is Supported on the Additional Ground, Among Others, That Petitioner's Complaint Failed to Allege Scien-ter Against Andersen.

Petitioner's Complaint and the Audit Committee Report incorporated therein, is devoid of a single allegation

that Andersen intended to deceive, manipulate or defraud GTE or that Andersen had any knowledge whatsoever of the transactions that were the subject of petitioner's suit. Accordingly, the Complaint fails to state a section 10(b) claim against Andersen under *Ernst & Ernst v. Hochfelder*, 425 U. S. 185 (1976).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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